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Office of Legislative Liaison

Washington, D. C. 20505

Telephone: 351-6121 27 Feb 85

TO: Joint Economic Committee
United States Congress

Attn: Richard Kaufman

Attached is a copy of China: The Impact
of Reform on the Economy in 1983 and Prospects
for the Future.

Liaison Division

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China: The Impact of Reform on the Economy in 1983 and Prospects for the Future

Introduction

China's economic performance in 1983 and early 1984 reflects the successes and failures of experiments with reform that have been underway since late 1978. Grain and cotton output reached new highs as agricultural reforms gave peasants a freer hand in farming. Growth in the industrial sector was strong, but Beijing had major problems improving efficiency. At the Party Plenum last month the reform wing of the party under Deng Xiaoping approved a comprehensive document on reform that builds on the success of agricultural reforms to push for more sweeping changes. If Beijing can successfully overcome the difficulties it will encounter in implementing its urban reforms, we believe significant economic gains are possible in the long run. Such successes would bode well for China's open door policy and could promote a broadening and deepening of China's ties with the United States.

Economic Results in 1983--Mixed Picture

Agricultural Production Up Sharply

Agricultural reforms were the centerpiece of China's effort to restructure its economy, and recent gains have given the regime the peg it needed to justify even more radical departures from orthodox Marxist economic practices.

-- In 1983, the total value of agricultural output jumped 9 percent, more than double the 4-percent goal set in the annual plan.

- Grain production--the key indicator--hit a record 387 million tons, more than 9 percent above the bumper 1982 crop.
- Grain imports fell to less than 13 million tons from 15 million tons in 1982.
- Cotton production showed an even sharper increase of 25 percent as China shed its role as one of the largest cotton importers and began small-scale raw cotton exports. Shipments of US cotton to China were indicative of this trend, falling steadily from a peak level of \$700 million in 1980 to only \$2 million last year.

China credits its experiment with market-oriented rural reforms for recent agricultural gains, although we believe better-than-average weather and price increases also played an important role. The contract responsibility system, which gives peasants effective control over acreage for periods of 15 years or more, sparked rural enthusiasm. Since the adoption of the responsibility system in late 1978, the Chinese have increased their annual grain production by 83 million tons--more than the entire annual grain production of Australia and Canada combined. A government decision to hike procurement prices for agricultural products also improved rural living standards. With procurement prices now 40 percent higher than in 1978, peasants have been willing to increase their use of fertilizer and other inputs, further boosting agricultural yields.

Beijing is also touting the reforms for their impact on rural employment. In pursuit of profits, an increasing number of unemployed and

underemployed peasants have begun to engage in either commercial activities in the service sectors--opening restaurants, repairing shoes, making clothing, cutting hair, etc.--or production of handicraft items. Beijing hopes by the end of the century to have about 40 percent of its rural labor force employed in non-agricultural production.

The sharp gains have left the peasantry much better off than it was prior to 1978. Rural residents have seen their annual income more than double over the period to about 300 yuan per capita (roughly \$150). Moreover, the gap between rural and urban living standards has narrowed significantly. Consumption by city residents rose at an annual rate of 7.2 percent between 1979 and 1983, while rural consumption shot up at a 14.7 percent annual clip. Consumer goods such as televisions, bicycles, watches, and fans are also beginning to work their way into the rural areas.

Energy and Transportation--Mixed Results

The energy sector provided Chinese policymakers with what was perhaps the most pleasant surprise of 1983.

- Primary energy output rose 6.7 percent, the fastest pace in five years.
- When energy saving measures are included, the gain comes to more than 9 percent.
- Much of the production increase can be attributed to improved recovery processes which helped boost oil output by nearly 4 percent to 106 million tons.

-- A new incentive system which allowed producers to market above-quota production at higher prices also had a major impact on coal--China's largest energy source--and probably boosted oil output as well. A newly instituted tax on energy consumption probably contributed to energy conservation efforts.

The transportation sector also achieved good results when measured against the low level of resources that Beijing devoted to it over the past few years. The 7.6 percent increase in goods transported last year came mainly from improved management of existing facilities. Burgeoning budget deficits starting in 1979 forced Beijing to scale-back its budgetary outlays and investment in transportation was especially hard-hit. The share of total investment in capital construction going to transportation and telecommunications dropped from an already low average of 18 percent in the 1971-75 period, to 13 percent in 1976-1980 and to 9 percent in 1981. Last year Beijing raised the proportion back up to 13 percent, but clearly the rate of investment is far short of China's needs.

Foreign Trade--A Growing Surplus

The foreign trade sector has experienced significant growth under China's open door policy. Exports in 1983 rose 2 percent to a record \$24 billion and imports showed a 10 percent increase to \$18.4 billion. The \$5.6 billion trade surplus, China's third consecutive large surplus, has drawn increasing criticism from Western trading partners.

Total foreign currency holdings, (including gold and SDRs), at yearend 1983 amounted to an unprecedented US\$20 billion, tenth largest in the world

and seventh largest if only foreign exchange is considered. We estimate the debt service ratio at the end of last year was only about 6 percent, one of the world's lowest. Despite an obvious and growing need for Western technology, Beijing has been unusually cautious about accumulating debt or spending its reserves. This reluctance to make major outlays for Western equipment probably stems from several factors, including Beijing's uncertainty about which projects warrant top priority, domestic financial problems, and bureaucratic constraints on the use of foreign exchange.

Military Sector--Aiding Economic Progress

With all the emphasis on economic reform the military has been asked to accept, for the time being, a smaller share of the economic pie. Chinese statistics show the proportion of total budget spending that goes to national defense falling from 17.5 percent in 1979--during China's border clash with Vietnam--to 15.3 percent in 1982. Last year the figure may have fallen below 15 percent. While Chinese budget figures undoubtedly understate total military spending (perhaps by as much as one-half), nevertheless, we believe the percentages give an accurate indication of the trend toward sacrifice the military has so far accepted.

Perhaps in part to attract military support for the cutbacks, Beijing has encouraged military industries to become more involved in civilian production and apparently has allowed them to acquire technology and to retain profits in the process. In 1983, civilian products (bicycles, transportation vehicles, clothing, etc.) accounted for 22 percent of the defense industry's total output, compared to only 6 percent in 1975. If this rate of increase is maintained, by 1990 about one-third of military production will go directly to civilian consumption.

Industrial Performance--A Different Story

China's industrial performance, when measured in terms of total output, also appeared more than satisfactory.

- The total value of industrial output rose a sharp 10 percent last year, well ahead of the planned 4 percent growth rate.
- Half of total output originated in the light industrial sector--where China feels its major potential lies--as opposed to only 42 percent in 1978.

Despite the apparent gains, Beijing has grown increasingly dissatisfied with the industrial sector's failure to come to grips with major problems of inefficiency and waste. Although small gains have been made in energy conservation, 20 percent of China's industrial capacity is idled by electricity shortages while Chinese enterprises continue to use three-and-a-half times more energy to produce a unit of output than their counterparts in the average LDC. Moreover, much of the output produced at this high cost is shoddy and outdated. For example, only 10 percent of the machinery and equipment currently produced is up to modern standards; the rest, the Chinese claim, is 1950s and 1960s vintage.

The economic reform program was supposed to be an all out attack on these problems, and Beijing openly declared its willingness to sacrifice growth while reforms worked their magic. The Sixth Five Year Plan (1981-1985) called for average annual increases in industrial output of only 2.7 percent, but demanded accompanying decreases in per unit output costs of 1 to 2 percent.

Actual results so far, however, have shown industrial output growing at an 8 percent annual clip and costs inching upward at the same time. The industrial reforms have clearly failed to accomplish their most important tasks.

Mounting Problems Associated With Reform

The failure of the so early piecemeal efforts to improve industrial efficiency provided ammunition to conservative elements within the Chinese leadership who were arguing for a return to tighter central control. Their cause was supported further by a host of new problems that emerged or were made worse by reform policies.

The devolution of decisionmaking authority, for example, threatened to untrack China's high priority infrastructure investment program. Enterprise managers, using their authority to make decisions on capital investment, ignored government pleas to hold the line on industrial investment; between 1979 and 1982 extrabudgetary investment in capital construction more than doubled. The increase not only drained funds needed for infrastructure investment, it also left China short of cement, glass, and other construction supplies needed to support the program. Many of the projects, when operational, also began attracting raw materials needed by larger, more efficient state-run enterprises.

Most serious, in the view of some Chinese leaders, the failure of the initial industrial reforms also threatened to limit China's long term growth potential. Beijing was counting on productivity gains from industrial reform to offset the impact that the falling investment rates would otherwise have on long term growth. But this has not happened. Since 1979, nominal investment in productive assets has risen at only a 4.5 percent annual pace compared to the 6.3 percent real growth of GNP.

Efforts to decentralize decisionmaking authority created financial problems that also threatened to derail the reform program. The fiscally conservative government has had to reconcile itself to 5 consecutive budget deficits totalling about 55 billion yuan. Treasury bonds were used to help finance the red ink without resorting totally to the inflationary printing of money, but the government has grown increasingly concerned about its inability to balance revenues and expenditures.

On the revenue side, budget shortfalls stemmed in part from the decision to cut back on growth in heavy industry--the major revenue generator. When heavy industrial output levelled off in 1980 and then declined in 1981, revenues suffered. And when the government tried to spark productivity by introducing a tax system that would allow enterprises to retain more of their profits, many enterprises began understating profits and overstating costs to avoid tax payment. The China Audit Administration, set up in September 1983 to monitor the situation, found errors and violations amounting to more than 600 million yuan in its first year of operation.

Even successful agricultural reforms compounded financial problems on the expenditure side. Procurement prices for agricultural products were increased sharply beginning in 1979 to boost rural incomes, while consumer prices for those products went relatively unchanged. The result was a huge gap requiring more than 140 billion yuan in price subsidies between 1979 and 1983. Price subsidies alone took nearly one-fourth of total state revenue by 1983 and more than offset the defense and investment cutbacks that were part of the government's budget balancing efforts between 1980 and 1982.

Factors Behind China's Mistakes

Given the magnitude of the changes Beijing introduced, the emergence of serious problems was not surprising. But on several counts, the government's piecemeal approach exacerbated existing difficulties. For example, rather than introducing a comprehensive, well-considered program, the industrial management reforms began as an experiment and then spread almost of their own volition. In 1979 about 4,000 enterprises throughout the country were allowed to experiment with decentralized decisionmaking authority. Less than a year later, 16 percent of all enterprises under the state budget--producing 60 percent of the total value of output and earning 70 percent of the profits--had been given expanded decisionmaking authority. In our view, neither party officials nor central authorities were prepared to surrender authority on such a large-scale on such short notice. Misunderstanding and bureaucratic infighting became major problems.

Lacking a comprehensive plan, Beijing was forced early on to make major alterations in the reform program. The frequent changes led factory managers to question the government's commitment to reform, and hence slowed the implementation process. For example, the government repeatedly altered its tax policy and demonstrated a great deal of uncertainty over how much autonomy local-level enterprises should have in distributing bonuses and in making investment decisions. For factory managers who survived China's Cultural Revolution by resisting any policy changes that deviated from orthodox Marxism, the government's vacillation was a signal to go slow in implementing change.

Beijing's most serious problem in promoting a transition to a more market-oriented economy was its failure to come to grips with its irrational price structure. Aside from the financial problems this generated, the price

structure--large parts of which date from the 1950s--conveyed no meaningful information on which economic decisions could be made. Since prices bore little relationship to production costs, enterprise losses were not necessarily attributable to either inefficiency or lack of demand. Beijing's insistence, therefore, that enterprises make profits had little realistic effect, as the government had no criteria for determining which enterprises should be forced into bankruptcy. By yearend 1983, one-fourth of all state enterprises were operating in the red.

Outdated fixed prices, moreover, meant that firms had no means of assessing their most profitable economic endeavors. Enterprises producing high priced goods requiring cheap inputs, for instance, made large profits regardless of efficiency or product quality. Even when there was no consumer demand for a firm's output, its profits were assured by the state's practice of procuring the commodity at the arbitrarily established price.¹ At the same time, the production of many popular consumer goods began declining or even stopped because such items yield little or no profit.

Nor could China's banking system help in the transition. During the Cultural Revolution the People's Bank of China had operated primarily as a cashier/accountant for the Ministry of Finance. The major function of the bank was to transfer funds at the ministry's bidding. Loans were made to meet plans regardless of the borrower's financial status or the efficiency of the project. Interest charges were held low, when assessed at all, and repayment

¹A study of 32 enterprises in Liaoning province revealed that 47 percent of all goods produced in 1983 were unmarketable or already overstocked.

was seldom enforced. The upshot of this policy was intense pressure from enterprises to secure funds for investment, without regard to the possible return.

Finally, the environment in which the seeds of urban reform were sown was much more hostile to change than that of the agricultural sector. Rural reforms gave agricultural decisionmaking authority back to the farmer, but urban reforms handed authority to factory managers who were ill-equipped for their jobs. Most acquired their positions during the Cultural Revolution as a result of their political orthodoxy, not their managerial talents. They lacked both the education and the expertise necessary to function in a competitive environment. Hence, it was not surprising that, for example, when Beijing gave managers the power to reward outstanding work with bonuses, payments were usually made on an egalitarian basis, across the board.

Pushing Ahead With Reform--The 1984 Policy Shift

From 1980 to early 1984, China's economic policies had something of a seesaw character, as economists and economic administrators debated the merits of tight planning versus market regulation, and of reform versus readjustment of the economic structure. At the top of the political structure, it appeared that Politburo elders Chen Yun and Li Xiannian favored a gradual approach to change, relying on more efficient operation of an improved planning apparatus. Opposed to them were Premier Zhao Ziyang and several of China's leading economists, who argued that earlier reform measures had not gone far enough and that there was a need greater reliance on the market, and hence more institutional change.

Earlier this year, the momentum shifted decisively in favor of the reformers, who, with Deng Xiaoping's support, apparently were given the

wherewithal to implement their programs. In January, Beijing issued Central Document No. 1, a comprehensive summary of rural reform measures and a clear call to expand the reforms, giving more opportunities to farmers to engage in commerce and "commodity production." In April, the State Council issued new regulations permitting factories and commercial enterprises to experiment with new wage programs. Less than a month later, the "Provisional Regulations on Greater Freedom for State-Owned Industrial Enterprises" were published, giving enterprises the right to:

- Produce whatever goods are in short supply after fulfilling State plans for their normal output.
- Set retail prices for industrial machinery and other means of production within a range of 20 percent around the state price.
- Decide what share of their income will go to production, expansion, reserves, or bonuses.
- Lease or rent equipment as long as proceeds go to upgrade existing facilities.
- Recruit technical specialists directly and develop pay standards.

Although many of these measures were little more than restatements of policies Beijing had experimented with during the previous three years, they signalled a renewed commitment to industrial reform.

Zhao's address to the May session of the National People's Congress (NPC) gave official confirmation to the policy shift. After a brief note of praise for agricultural reforms, Zhao devoted nearly two-thirds of his speech to the "urgent" need for "quickening" reform in the cities. Specifically, Zhao called for:

- Implementation of the second stage of China's tax reform program to give enterprises even greater financial autonomy.
- Experimental restructuring of the managerial system in the construction industry, replacing financial appropriations with bank loans, using public bidding procedures to issue contracts, and revamping the material distribution system to alleviate shortages.
- Better utilization of educated technicians in the planning and management process in enterprises.
- Reform of the commodity circulation system to facilitate the flow of goods between town and country, and the exchange of goods between different regions.

By late June, various Chinese media were publishing articles calling for experiments with such market-oriented practices as forcing state banks to compete against each other for deposit and loan business, and allowing domestic enterprises to issue stocks, bonds, and other securities. Perhaps the most notable shift, however, was the emergence of a host of articles advocating an early resolution of the price question. Prior to this time--

despite the view widely held by Western and Chinese economists alike that the entire experiment with market tools could not succeed within the framework of China's irrational prices--only the most daring advocates of economic reform suggested moving quickly to tackle the potentially explosive issue of price reform.

The October Party Plenum

The most irrefutable evidence of the reformers' strength came during the Third Plenary Session of the Chinese Communist Party's 12th Central Committee, which convened for a single day on 20 October to endorse a sweeping "Decision on Reform of the Economic Structure." The plenum was preceded by six days of "preparatory meetings," at which the document was presumably explained in detail to various constituencies, though it probably underwent little change. The Central Committee's "Decision" committed the party to a comprehensive reform program that if, implemented as planned over the next five years, will change the face of Chinese socialism.

Although the decision is a bold and politically risky attempt to confront fundamental problems in the Chinese economy, it is not, in our view, a turning point for economic policy, nor is it a surprising announcement of some historic new trend, i.e. the reintroduction of capitalism. Rather, it represents an acceleration of the reform drive that began in late 1978, and a deepening of the shift away from concentration on rural policy and toward urban reform that Zhao introduced at the May NPC.

The document cites four characteristics of China's Soviet-style economic structure that have drained enterprises of their initiative and vitality:

- The lack of clear distinction between functions of government and industry.
- "Excessive and rigid" state control.
- An inadequate role for prices and markets.
- The practice of "absolute egalitarianism."

It demands the creation of a "new socialist economic structure with Chinese characteristics," where major assets continue to be owned by the state, but where enterprise managers are free to respond in a competitive way to market signals. In the words of the document, the party seeks to create a system where "ownership can be duly separated from the power of operation."

A New Relationship Between Government and Enterprise.

The structural changes called for in the decision are basically intended to remove the state and party from most day-to-day business decisions. To accomplish this, the entire national economic planning apparatus will be revamped. Strict mandatory plans, which previously dictated production and allocation quotas for most sectors of the economy, will now be applied only where essential commodities are involved.² According to the decision, other

²China recently published a partial list of essential commodities, which included coal, oil and petroleum products, steel, non-ferrous metals, timber, cement, chemicals, electricity, munitions and other items. Agricultural products on the list included cereals, cotton, edible oils, tobacco, pigs and some aquatic products.

products and economic activities, which are far more numerous, should either come under guidance plans or be left entirely to the operation of the market.

Guidance plans are to be "rough and flexible" guidelines on how much of each particular good the state deems desirable. Enterprises will be required to give first consideration to these plans, but where local conditions make implementation of guidance plans unreasonable--for example, because of energy shortages or peculiarities in supply and demand--the firms will be free to deviate from plan without penalty. Enforcement of guidance plans will be accomplished mainly through the use of economic levers such as interest rates, bank lending policies, and taxes.

Enterprise management responsibilities are to be greatly expanded. Specifically, most enterprises are expected to become "relatively independent economic entities," responsible for their own profits and losses. Not only will they have more control over what and how much they produce and over their finances, they will also have authority--within as yet undefined limits--to hire and fire workers, to set wages and bonuses, and even to set product prices.

Although the new program calls for a weakening of the role played by state bureaucracies, their power nevertheless remains significant. By any objective standard, China's economy will remain socialist in its essentials. In addition to the continued importance of the central planning apparatus and strict control over products of national importance, the state will continue to appoint and remove key enterprise managers and hence to exert a powerful, if indirect, influence on production decisions. Moreover, when enterprises experience financial problems, it is the state that will determine which firms will be subsidized, and which will be forced to merge or shut down.

Price Reform--The Key to Success.

The plenum brought to an end the party's reluctance--perhaps for fear of sparking potentially destabilizing inflation, hoarding, and speculation--to come to grips with the problem of irrational prices. The plenum document explicitly recommends establishment of a "rational price system," calling it "the key to reform of the entire economic structure." The fact that Beijing hopes to have its now totally irrational price system corrected in only five years is an indication of the party's commitment to rapid reform.

To carry out its program, Beijing will gradually reduce the number of items subject to state-set fixed prices. Most product prices will be allowed to fluctuate--according to changes in supply and demand--within narrow bands set by the state. Floating prices will be used for a small number of consumer products and for most services provided by individual entrepreneurs. For essential goods, the state will retain tight control, but major adjustments are probable even here as Beijing attempts to bring its raw material and energy prices into line with the current world economic situation.³

Recognizing the sensitivity of the local population to price changes--many Chinese remember the hyperinflation of the late 1940s--Beijing's plans for rationalizing prices are cautious. The plenum document emphasizes that price reform will be implemented "gradually, in a step-by-step" fashion. It promises that "the real income of urban and rural inhabitants will not go down as a result of price readjustments." The document also warns potential entrepreneurs that it is "absolutely impermissible for any unit or person to boost prices at will by taking advantage of the reform."

³Coal, which is greatly underpriced in China, will probably be one of the first targets of state-controlled price adjustment.

The Short-term Outlook

The current effort to speed up industrial reform came too late to have much impact on economic performance in 1984. Even so, the economy will probably boast rapid growth again this year. Industrial production rose at an 11.6-percent rate in the first six months of 1984 with light and heavy industry moving at matching rates of 11.5 and 11.7 percent respectively. We estimate that China's GNP for the year may rise 10 percent. Energy output during the first half increased a 7 percent; however, we believe that output for the year as a whole will run about 6 percent, because of fourth quarter problems in the power sector.

The agricultural sector is also expected to perform well again this year. Grain production may top the record harvest of 1983 by 5 percent. Despite the increase, the PRC claims it will honor import commitments under its grain agreements with the United States, Canada, Australia, and Argentina. The record harvests are, however, making it less likely that China will want to renegotiate expiring agreements. Cotton output will probably also rise sharply again this year, perhaps by as much as 20 percent. (C)

There are preliminary indications that the domestic financial situation may also be mending somewhat. State revenue collections reportedly rose 23 percent during the first six months of 1984 as Beijing's new Audit Administration began conducting spot checks on enterprises across the country. On the expenditure side, however, Beijing apparently continues to be plagued by large price subsidies and increasing demands for budgetary outlays for infrastructure. We expect China to run about a 6 billion yuan deficit for the year, slightly less than in 1983, but considerably larger than the fiscally conservative government prefers.

China's international financial picture--already one of the strongest worldwide--will probably improve further in 1984. So far this year, preliminary figures show exports continuing to outpace imports by a wide margin. Although we expect this trend to begin reversing itself soon, export growth will remain strong during the year--at about 10-15 percent. Imports could approach \$24 billion or a growth rate of 25-30 percent on the strength of Western equipment and technology sales. The resulting \$2-4 billion trade surplus will probably boost total reserves to more than \$23 billion by December 1984, and China's debt service ratio could drop another percentage point to less than 5 percent.

Economic Problems Ahead.

Introducing price reform into China's shortage-driven economy probably poses the most immediate threat to the reform program. The plenum's call for price reform reportedly sparked a few bank runs and some panic buying last month, despite assurances that prices would be adjusted slowly and that consumer income would not be allowed to suffer. Further problems can be expected as Beijing attempts to bring prices for essential goods such as cereals, industrial raw materials, and coal into line with costs.

Beijing is committed to immediate price adjustment, but it also clearly recognizes the potential for panic that price reform raises, and will move very deliberately to implement changes. In fact, we believe the risk that the leadership will move too slowly with essential price adjustments (and stall the entire reform package) is greater than the risk that too rapid an advance will spark economic instability. Nevertheless, it is safe to assume that price reform will be somewhat inflationary in the short run. Most adjustments will probably be upward, and important products such as coal, oil, and certain

foodstuffs will eventually undergo steep revisions. The reforms may occasionally spark bouts of panic buying as consumers draw down savings deposits that are now at record levels. Beijing is most likely to respond to these periodic bouts by limiting bank withdrawals, ordering producers to hold the line on prices, and by raising interest rates and taxes to discourage consumption.

Another economic hurdle that the leadership must cross in the immediate future is the question of corporate bankruptcy. Last year, nearly one-fourth of China's industrial enterprises were unprofitable, and this year, even after the government exerted strong pressure for improvement, 16 percent are still operating in the red. Clearly, Beijing cannot allow a massive shutdown of such a large portion of its industrial base. Furthermore, until reform is in place, there is no effective way of determining which enterprises deserve closing. Despite the fact that continued subsidization of losing enterprises encourages inefficient behavior all around, we believe Beijing will probably be cautious and allow a large number of inefficient firms to continue to operate.

Where the government decides some firms must be forced to close, the accompanying unemployment problems may be locally destabilizing. Beijing has historically prohibited the free movement of the population in order to prevent massive migration from the countryside to the cities. If major industries are allowed to fold, certain geographic areas could face high unemployment rates for long periods of time. We believe this problem will reinforce Beijing's inclination to accept inefficiency rather than promote other serious problems.

In light of the many problems, we do not expect the benefits of urban reform to match those experienced under the agricultural reform program. But

neither does Beijing. The government is allowing itself five years to get the program in place and probably will hail even minor improvements in efficiency during that period as evidence of success. The fact that Beijing is going into this program with its economic eyes open increases the probability that it will be able to resist pressures to revert to tight central planning when problems arise. Nevertheless, the next year will provide a critical test of the government's willingness to accept the dislocations necessary to carry the program through.

Longer Term Prospects

The Agricultural Sector--More Gains

In the longer term, the question of how well the economic reforms will achieve China's avowed goal of quadrupling output by the year 2000 depends critically on several factors. In agriculture, many of the productivity gains accompanying the introduction of the contract responsibility system were one-time achievements. Future gains will probably come more slowly as farmers gradually introduce new technology and as more underemployed laborers leave the land to pursue non-agricultural employment. Nor can Beijing's good luck with weather continue indefinitely. Consecutive years of widespread natural disaster could cut crop yields dramatically, especially if laborers under the contract responsibility system resist leaving their own plots to engage in dike repair or rescue operations that may not be directly beneficial to them.

Other factors, however, bode well for continued improvement in agricultural productivity. The rapid increase in production of consumer durables will continue to motivate Chinese farm workers. Commercial reforms

that speed the delivery of farm goods to urban markets and urban goods to the rural sector will also help. If banking reforms boost domestic interest rates further, as we anticipate, this too should give the already cash-rich rural population additional incentive to boost agricultural output.

On the whole we believe the positive factors outweigh the negative and we anticipate annual gains in the value of agricultural output of between 5 and 7 percent over the next few years. The gains should enable Beijing in most years to devote the bulk of its foreign exchange reserves to equipment and technology rather than to agricultural imports. Nevertheless, as both rural and urban incomes expand, food consumption will probably also rise sharply. This--combined with the massive problem China already has in moving grain to urban consumers--will, we believe, result in continued purchases of sizable quantities of US grain, even in years of better-than-average weather. Poor climatic conditions in consecutive years would probably deplete grain reserves and bring China back into world markets in a big way.

Military--More Technology But Limited Expenditures

With the renewed emphasis on economic reform we expect defense spending to remain at relatively modest levels. To bring about qualitative, if gradual, improvement of defense capabilities and to appease the military leadership that is eager to modernize, Beijing will, however, probably continue to increase the import of Western military-related technology. The purchase in 1984 of 24 Sikorsky medium lift helicopters for \$150 million is evidence of this turn westward. The military has a strong economic argument in support of its desire to boost imports; since 1979, exports of Chinese military hardware abroad have generated several billion in foreign exchange, well in excess of anything currently being requested.

Industry--Major Obstacles Ahead

Long term success in the industrial sector depends heavily on how fast and effectively some of the new reforms can be implemented. Despite Deng's efforts, there is still considerable opposition within the party bureaucracy to further expansion of the reforms. There are those with grave ideological reservations about the program, and those who fear that Deng's concomitant demand that the party upgrade the expertise of party leaders, as well as enterprise managers, will cost them their jobs. Since the task of implementing new reforms rests heavily on these mid-level cadre, we expect progress to be neither smooth nor rapid, as they seek by various bureaucratic methods to impede the progress of changes they view as threatening.

Beijing already has achieved some success in removing party cadre from the economic decisionmaking process and installing trained technicians in their place. Hu Yaobang recently told Japanese officials that nearly 1 million veteran cadre have left their posts since the government began its efforts to upgrade its managerial expertise, and 2 million will have retired by yearend 1984. Further progress in this political aspect of reform will improve the chances for overall success.

Other institutional changes needed to buttress reforms will probably continue to develop slowly. Despite major reforms in the banking system, there is evidence that local pressures, not economic factors, continue to determine the direction of loans. Nor has Beijing been very successful at replacing budgetary allocations with loans. This suggests that enterprises still lack the incentives necessary to force them to make efficient investment decisions. The productivity of capital is unlikely to show marked improvements until Beijing achieves better results with its banking reform.

Efforts to revitalize the commercial system may generate considerable efficiency gains. The difficulties that stem from China's inadequate road and rail system are compounded by bureaucratic problems that accompany tight state control over transport activities. Although it would take a massive investment program to eliminate Beijing's transportation problems, we believe that the increased involvement of individuals and cooperative enterprises in middleman activities will alleviate a significant number of the distribution problems that now plague Chinese industries.

We anticipate that, over the longer term, devolution of the decisions on hiring, firing, wages and prices to managers will improve enterprise efficiency. As more enterprises are required to market their own products, quality will undoubtedly improve and a wider variety of goods can be expected on Chinese markets. Since small firms producing nonessential goods will be given the most leeway, they will probably be the first to show marked improvements. Progress within large, state-run enterprises producing major goods will, we believe, occur more slowly.

Despite some short term problems as the government carries out price adjustment policies, we do not believe there is significant risk of serious long-term inflation. For this to occur, the government would have to be willing to sustain the increases in consumer demand by printing money. Although some subsidies or wage increases will be offered in the early stages of the adjustment process--to help ease concerns about eroding purchasing power--the conservative government is unlikely to resort to long-term use of the printing press to finance consumer spending.

On the whole, we believe the gains from current reform will lead to some efficiency gains as early as next year. Although Beijing is likely to be disappointed at the rate of progress, the fact that the economy is moving in

the right direction should give impetus to further change. If, however, Beijing backs away from price reforms, the overall reform program could lose steam rapidly. Under such a scenario, Beijing might be forced as early as 1986 to move back toward greater central control.

If Beijing can resist political pressure to ease off on reforms in the face of mounting problems, we believe long-term productivity will increase and economic growth will accelerate. Government efforts to encourage surplus labor to take up private commerce and service activities have considerable potential for increasing both agricultural and industrial productivity. The renewed emphasis on enterprise autonomy also bodes well for productivity increases, some of which will go unobserved in Beijing as enterprises attempt to understate profits to avoid taxes.

A final threat to the continuing rapid advance of economic reform is the health of China's 80 year old leader, Deng Xiaoping. Although Deng's successors are firmly committed to the reform policies--and indeed, Hu Yaobang and Zhao Ziyang have staked their political futures on success--they still lack Deng's political clout and tenacity. If one of the more prestigious advocates of central planning--such as Peng Zhen, Li Xiannian or Chen Yun--is able to succeed to Deng's pivotal role as power broker and final authority, we believe that he might at least attempt to curb some of the more experimental aspects of reform. In our view, however, a modicum of success for economic reform programs will enhance the prospects for Hu and Zhao to succeed Deng smoothly.

A Worst Case Assessment.

Deng and his allies have indicated they expect that the early going will be rough and are prepared to ride out short term problems, such as panic

buying and isolated runs on banks. If those problems persist, or get worse, critics of reform will almost certainly seize on the dislocations to call for a return to direct central control, even though this alternative has demonstrably failed to promote efficiency in the past. Although reform advocates seem to hold the balance in party councils now, party and military conservatives could coalesce into a potentially powerful political bloc if economic problems became socially destabilizing.

Even if Beijing manages to weather its inevitable short-term problems, Deng's death or a combination of incremental breakdowns--such as floods, drought, a succession of poor harvests, a rapid rise in undesirable side effects of economic expansion such as price gouging, speculation, or graft--could over the longer term tip the political scales against reform and lead to a retreat.

Retrenchment on reforms would confront the party with serious sociopolitical difficulties as it sought to reassert its control down to the local level. At a minimum, the party leadership would again be seen as vacillating and unconcerned with the common welfare, precisely the image it seeks to dispel by implementing new policies. At worst, disaffected peasants or workers might engage in active or passive resistance. The failure of reform would almost certainly bring on a protracted period of political instability, as leaders struggled for the right to affix the blame.

Implications for the United States

In our judgment, implementation of the reforms will both broaden and deepen China's ties with the United States and the West. The emphasis on technological innovation at the plant level, foreign capital acquisition, and increased joint ventures will expand investment and trade opportunities for US

and Western businesses. In addition, we expect that Chinese enterprise managers will take advantage of their new flexibility to tap the West for increased amounts of information, training, and managerial expertise.

At the same time, however, the reforms will aggravate some current problems in US-China relations. It can be expected that Chinese enterprises will want greater access to Western markets to sell their products--largely textiles and light industrial goods--so Beijing's pressure on Washington to lower trade barriers will increase. Similarly, Beijing will probably press Washington harder on technology transfer in response to both its needs for economic and military modernization and the demands of its own enterprises. It is also likely that China will reduce its grain imports from the West as its agricultural production continues to improve.

In the five years since the "open door,"--one of China's most fundamental reforms--was introduced, two-way trade with the United States has burgeoned from \$1.1 billion in 1978 to a peak of \$5.5 billion in 1981 before receding slightly to \$4.4 billion last year. US investors have reportedly put \$90 million into joint ventures in China, US oil companies have probably spent an additional \$300 million in offshore oil exploration, and Occidental Petroleum Company is involved in a coal mining joint ventures that may generate \$400-600 million in machinery, equipment, and technology sales. As long as the reformers continue to hold China's economic policies we believe these economic ties with the West will expand.

Beijing's continued success with economic reform could also prove to be a tempting example for other countries struggling with central planning. Chinese economists have already spent a great deal of time studying East European experiments with economic reform. Articles in Chinese economic journals have been especially favorable toward the Hungarian experiment where

major reforms have been under way since 1968. Beijing is also reportedly encouraging the North Koreans to learn from the Chinese reforms and relax their tight control over the economy. As China's program proceeds other countries--including some LDCs and even a few of the East European nations that China patterned its early reforms after--may look more closely at making wider use of market-oriented programs.